

# Joint Ventures between Nonprofit and For-Profit Organizations

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# Summary of Topics

- Orientation – kinds of joint ventures and parties' motivation
- Standards under applicable revenue rulings, cases, and other sources
- Adverse consequences if standards not met
- Practical pointers

# ORIENTATION

- Joint venture (JV) typically between 501(c)(3) public charity and for-profit entity
- Examples
  - Healthcare, such as hospital JV, diagnostic imaging center JV, ASC JV
  - Low income housing JV
- Typically flow-through entity JVs
- Activities of the JV are attributed up to the nonprofit entity

# Nonprofit's Motivation to Participate in JV

- Access to expertise, capital, other
- Enables it to advance charitable purpose
- Enables it to take advantage of tax credits (e.g., low income housing) which EO can't utilize otherwise
- Other

# For-Profit's Motivation

- Access to EO's good name in community
- Access to EO's services
- Access to gov't benefits not available to for-profit entities
- New way to earn revenue
- Other

# STANDARDS UNDER APPLICABLE REV. RULINGS, CASES, ETC.

- Prior to 1980, IRS position in most cases was that JV per se inconsistent with continued tax-exempt status (see GCM 36293 (May 30, 1975))

## Plumstead Theatre Society, Inc. v. Comm'r,

74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9<sup>th</sup> Cir. 1982)

- 2 prong test: (1) charitable purpose & (2) private benefit
- Tax Court found (1) EO's participation in JV furthered its charitable purpose (promotion of performing arts), and (2) EO retained sufficient control of the activities of the venture so no more than an incidental private benefit to the non-exempt investors (limited p'ship had interest in one production only; non-exempt limited partners had no control over the way EO operated or managed its affairs; no limited partner was an officer or director of EO)
- Tax Court held Plumstead was operated for public (not private) benefit consistent with tax-exempt status

# Rev. Rul. 98-15 (Mar. 4, 1998)

- 2 examples of whole hospital JV: 1 good and 1 bad
- Key distinction is whether EO effectively controls the JV: structural (voting) control and contractual control
- Good facts:
  - EO appoints majority governing board members
  - Majority of governing board must approve major decisions relating to LLC's operation
  - Governing docs require hospital to be operated to further EO's charitable purpose of promoting health for community, and charitable purpose overrides maximizing profitability
  - Mgmt co unrelated to non-exempt entity, 5 year term of contract



# Redlands Surgical Services v. Comm'r

113 T.C. 47 (Jul. 19, 1999), aff'd, 245 F.3d 904 (9<sup>th</sup> Cir. 2001)

- Ancillary JV (vs. whole hospital JV) - 50/50 gen'l partners
- Nonprofit corporation whose sole activity was serving as one of 2 equal general partners in a lim.partnership that operated an ASC did not qualify for tax exemption because it lacked a controlling interest and therefore could not assure that operations would be in furtherance of charitable purposes (veto power, but no initiation power) – conferred a private benefit by ceding control
- Bad facts suggested nonprofit ceded control:
  - Long term mgt contract with for-profit partner's affiliate
  - Arbitration mechanism did not require arbitrator to decide in favor of charitable purpose if there is a deadlock between partners
  - Noncompetition provision limited nonprofit's affiliated hospital entity

# St. David's Health Care System v. U.S. 349 F.3d 232 (5<sup>th</sup> Cir.2003)

- Whole hospital JV – 50/50 board
- Provision of charitable services not enough – nonprofit cannot qualify for tax-exempt status if its activities via the partnership substantially further the private, profit seeking interests of the for-profit partner.
- Determining factor – control of the JV – not clear
- Court engaged in careful scrutiny of partnership and management agreements
- Remand to jury trial to find if EO ceded control

## Rev. Rul. 2004-51 (May 6, 2004)

- Ancillary JV 50/50 board w/ safeguards
- Tax-exempt university formed LLC with a for-profit company for the purpose of offering off-campus teacher training programs using interactive video technology
- IRS concludes EO may participate without endangering its tax-exempt status or having its allocable share of income from LLC classified as UBIT – even though EO does not have majority control

# Rev. Rul. 2004-51 -- Favorable Factors for EO's Continued Tax-Exempt Status

- EO maintains substantial activities outside JV that further exempt purpose, and activities w/i JV are only insubstantial part of its total activities
- Indicia of EO's control:
  - Gov doc states LLC's sole purpose is to offer teacher training seminars off-campus; limits activities to conducting seminars; requires the LLC not to engage in activities that would jeopardize EO's 501(c)(3) exemption
  - EO decides curriculum (same as on-campus content), training materials, instructors
- Gov docs require arm's length FMV contracts

# Rev. Rul. 2004-51 -- Income from JV Not Subject to UBIT

- If EO controls the aspects of the JV that further the EO's exempt purpose, income derived from the ancillary JV should not be subject to UBIT

# PENALTIES

- Denial or loss of nonprofit's tax-exemption
- UBIT
- Intermediate sanctions – IRC 4958 - excise taxes on transactions that provide economic benefit that exceeds the value of the consideration received by the tax-exempt entity (example: IRS Information Letter 2005-0051 (January 26, 2005) – ancillary JV between EO hospital and physicians)
- Tipping
- Other

# PRACTICAL POINTERS

- Charitable purpose – JV's activities further EO's charitable purpose
  - EO's Board Planning Minutes
  - Operating documents (state exempt purpose; charit. purpose override clause)
  - Actual operations (e.g., is JV hospital complying with community benefit standards?)
- Not private benefit – EO control
  - Operating documents
    - Make up of governing board; Appoint/remove President/CEO
    - If less than maj board control, give EO veto power; initiation power; exclusive decision-making regarding items substantially related to exempt purpose
    - Override clause
    - Arbitration clause – arbitrator bound by override if dispute
    - Watch out for noncompetition provisions against EO
  - Arm's length transaction (EO got FMV for contribution; equit, profit sharing; fair deal)
  - Management contract (watch out for long contracts with for-profit entity's affiliate; reserve EO control)
  - Other (e.g., shelter EO's assets from liability, to extent possible)
- Other: Healthcare JVs (community benefit standard, watch out for joint venture anti-kickback and other healthcare regulatory concerns); Low incoming housing (e.g., BOE Rule 140.1); Other

- *Thank you for your attention.*
- *This presentation is for educational purposes only and is not intended to constitute legal or tax advice. If you have questions regarding a particular joint venture arrangement or related issues, you are advised to contact your attorney and/or tax advisor who has experience in these matters. Original source materials, which may include other materials that are not included in this presentation, should be consulted. Changes in the law should be monitored.*